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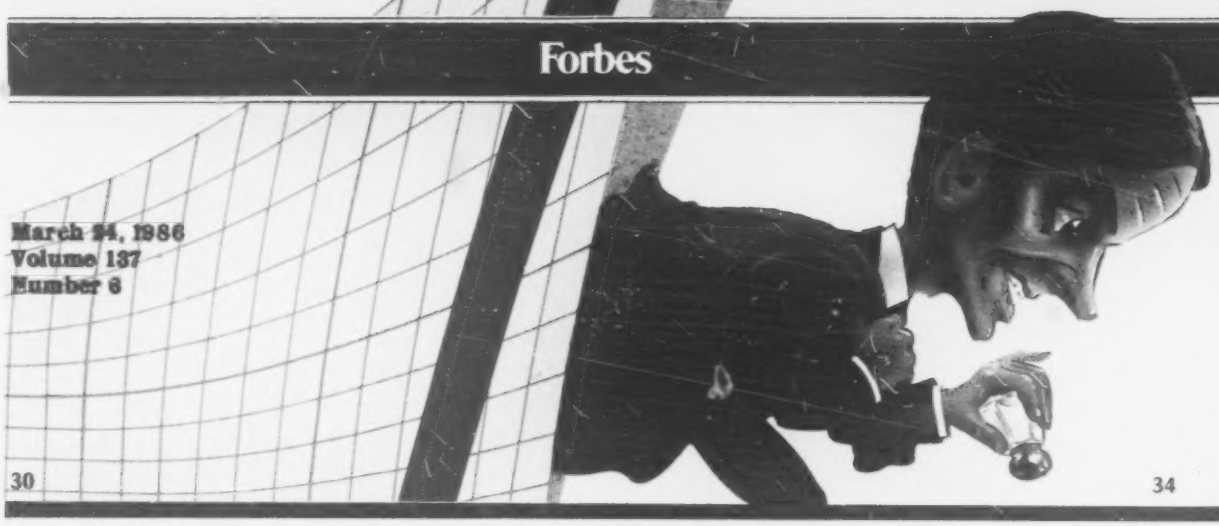

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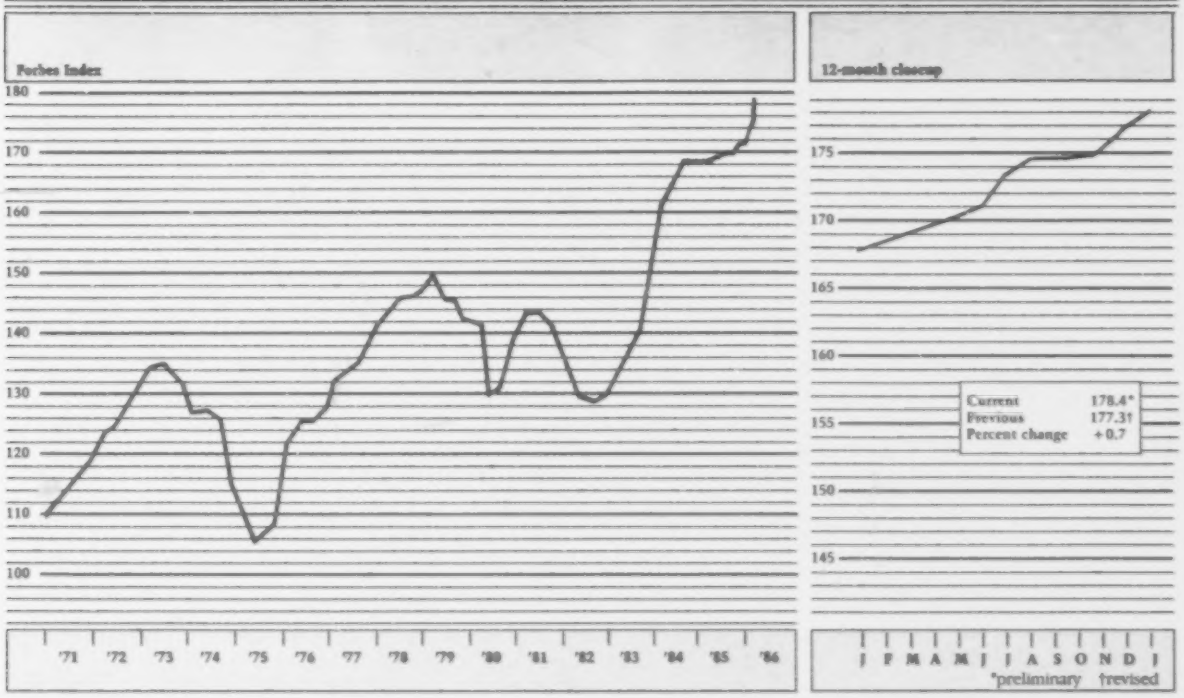
Cover chart by Andrew Christie; top inset, Douglas Fraser

The Forbes Index



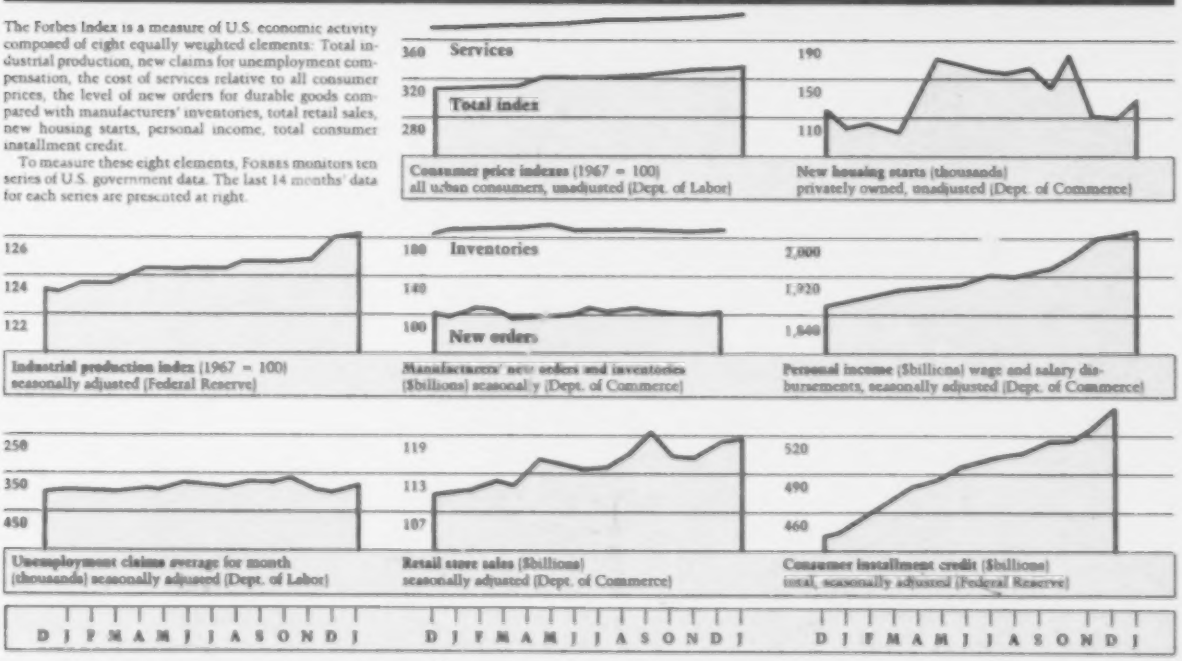
Love those low rates. The Forbes Index rose 0.7% during the latest reporting period, the largest month-to-month increase since last August, bringing it to a new alltime high. One big factor: Housing starts, responding to declining mortgage rates, jumped 3.8% over the previous month and stand some 13% higher than they were at the same time last year. Two other components in the Index also helped to give it a lift. Industrial production increased 0.3%, while personal income, after adjusting for inflation, went up 0.9%.

Inflation was 0.3%, or 4.1% at an annual rate. But declining energy costs, yet to have a significant impact on retail prices, should serve to moderate any increases in other elements of the CPI over the next few months.

The Forbes Index Components

The Forbes Index is a measure of U.S. economic activity composed of eight equally weighted elements: Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, the level of new orders for durable goods compared with manufacturers' inventories, total retail sales, new housing starts, personal income, total consumer installment credit.

To measure these eight elements, FORBES monitors ten series of U.S. government data. The last 14 months' data for each series are presented at right.



Forbes

Mutual funds are sensible in theory and often effective in practice. But too much success—just look at those startling sales numbers—is leading to wretched excess and. . .

The game is getting out of hand

By Allan Sloan
and Laura R. Walbert

"The mutual fund industry today is being driven by people who have no sense of history."—Michael Lipper, president, Lipper Analytical Services

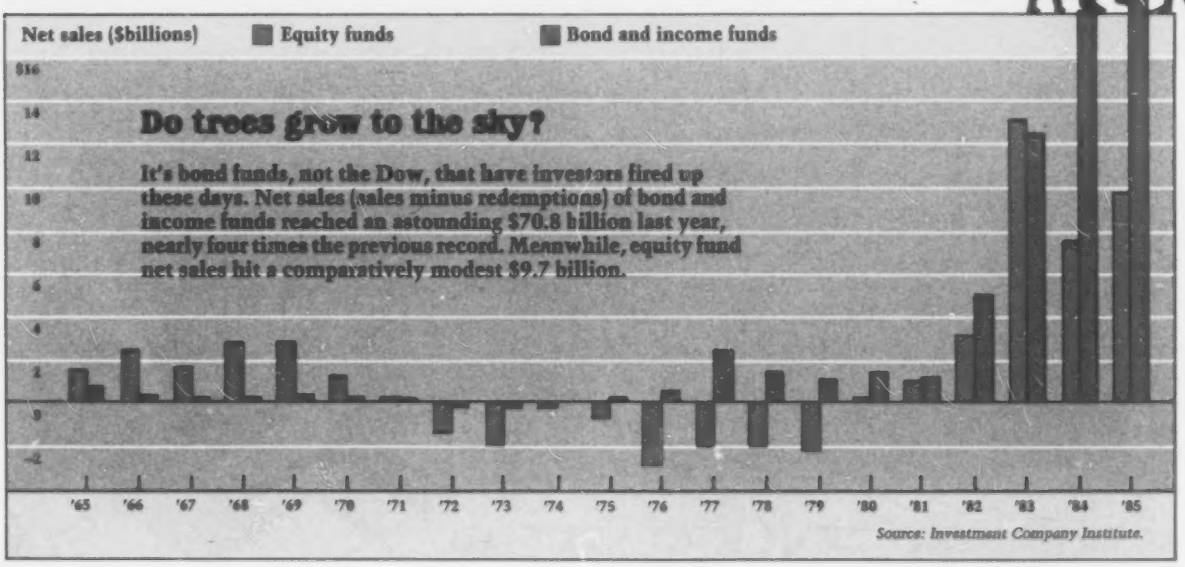
"Unless trees grow to the sky, we are going to end up with investors who are furious."—John Bogle, chairman, Vanguard Group of mutual funds

WHEN THE STOCK MARKET and the bond market are incredibly strong, when investors are gobbling up mutual fund shares at the astounding rate of nearly half a billion dollars per business day, it seems almost un-American to ask two simple questions: What the hell is going on? And can it possibly last?

We aren't asking these things to be reflex contrarians, looking for clouds because others discern only silver linings. We ask because there are increasingly clear signs that the mutual fund business is once again entering a period of wretched excess—signs that fund veterans like Mike Lipper and John Bogle see clearly, and are candid enough to acknowledge, but that the great majority of investors discern only dimly, if at all.

These signs include:

- the mad stampede by investors into bond mutual funds;
- the misleading advertising and promotion practices of some funds;
- the imposition



of hidden fees, so-called 12b-1s, on investors in 570 funds;

- the proliferation of bond and equity funds, from 460 five years ago to 1,070 now;
- the absurd increases in share prices of publicly traded mutual fund management companies;
- the rush by some fund managers to unload shares in their companies on the public.

Readers old enough to recall that the Miracle Mets won the World Series in 1969 ought to have the feeling that all this bustle in the fund business is familiar stuff. If nothing else, they should remember how the now legendary Jerry Tsai *(see box below)* brought out the Manhattan Fund just as investor appetite for "growth stocks" was peaking, then sold his fund management company for $27 million shortly before growth stocks crashed. Tsai made out nicely, but hardly anyone who bought anything from him at the time did. Tsai is now vice chairman of American Can Co., which plans to sell 15% of its fund management company to the public for more than $70 million. If Tsai thinks this is the time to sell, do you think this is the time to buy?

The theory of mutual fund investment remains sound—hundreds of small investors pool their money and a professional manages it. Indeed, as full-service brokerage houses increase commissions in their struggle to stay profitable, more investors will be priced out of buying stocks and bonds and thus will be driven to mutual funds. But even the fund business is not immune to financial manias that recur every generation or so.

Consider 1968-69, when "growth stock" fever became pandemic. Investors poured the then huge sum of $5.6 billion into equity funds, amid euphoric predictions that the fund industry would thrive forever. The bloodbath that ensued when growth stocks collapsed caused such revulsion that equity funds stayed in the doghouse until 1982, when the bull market in stocks started.

This time it's bonds that are running wild. Investors bought an amazing $71 billion (net of redemptions) of bond fund shares last year, and sales this year are running well ahead of last year.

Fund boosters argue—what else?—that this time is different, that the Sixties boom was unsustainable, but that investing in U.S. government bond funds is rock solid. Baloney. The "safe high yields" of 1986 are every bit as evanescent as the "one-decision" growth stocks of 1968, and they will come to the same bad end. Unless the fund industry puts a stop to such hype, the fallout from the inevitable disillusion will damage mutual funds' reputations as the growth stock collapse did.

Bond funds are drawing buckets of money because investors grown accustomed to double-digit yields are feeling deprived as yields on short-term investment drop into the 7% area. This makes bond funds an easy sell. Who can turn down a "safe" 10% when the local bank is offering a crummy 7.5% on a CD? Many of the bond fund prospectuses now in circulation feature a reassuring symbol—a U.S. flag, the Capitol dome. High yield without high risk.

But unless the laws of economics have been repealed, can there be high yield without high risk? To be sure, investors in U.S. government bond funds run no risk of default: Uncle

Jerry-built

Gerald Tsai has a gift for anticipating financial manias. Tsai, vice chairman of American Can Co., had the company buy American General Corp.'s mutual fund management company for $38 million in September 1983, before the fund business boomed. Good timing. American Can has taken out $55 million in dividends so far, plans to sell 15% of the management company to the public for more than $70 million and will still own American Capital Management & Research stock with a market value of more than $400 million. Half a billion dollars' profit by shuffling paper. A lot easier than making cans.

American Can's Jerry Tsai Ken Korsh
Nice timing, and a half-billion profit.

The fund company's profit rose from $11 million (45 cents a share) in 1984 to $26.6 million ($1.10) last year largely because of commissions and fees from its American Capital Government Securities fund, which grew from $770 million in assets at year-end 1984 to $4.76 billion at year-end 1985. Given the tenuous nature of the bond fund boom *(see story)*—and the particularly tenuous nature of American's fund, which largely sacrifices the possibility of capital gains by selling options that add a mite to current income—can fund company profits double every year?

At a proposed $20 to $23 a share and a P/E of 18 to 20, this offering is no more exotically priced than the offering made by John Templeton, who unloaded 25% of his Templeton International on the public for 20 times earnings. Templeton sold his shares on the London Stock Exchange, where there are no Securities & Exchange Commission regulations. Would Templeton buy a stock as richly priced as Templeton International for his funds? He begs off, saying securities rules won't let him answer us.

Dreyfus Corp. has chosen the present moment to raise $200 million by selling new stock at the current 22 times earnings. And T. Rowe Price Associates, another prominent manager, plans to go public at between 18 and 21 times earnings. Most of the money will go to former employees who sold their stock to the company in previous years; the rest to insiders who are selling now.

The conventional wisdom has been that mutual fund companies' stock is a better investment than mutual fund shares are. But at these prices—and with this much insider selling—you have to wonder whether that's still true.—**A.S. and L.R.W.**

The big guns

Each of the 13 bond funds in the table grew by more than $1 billion last year. Together, they accounted for half the $71 billion in net sales achieved by the 500 bond and income funds. Investors love the high current yields these funds claim. But notice what liberties the funds take with yield calculations. Many boost yield by adding short-term capital gains, often earned by writing options, to interest income. Some quote yield based on

Fund	Total assets 12/31/84 (millions)	Total assets 12/31/85 (millions)	1985 distributions per share: income dividends	1985 distributions per share: capital gains	1985 distributions per share: total	Offering* price 12/31/84
Van Kampen Merritt US Govt Fund	$100	$1,810	$1.71	$0.24	$1.95	$15.82
PaineWebber Fixed Income-GNMA	101	1,840	1.26	—	1.26	10.21
Franklin Custodian-US Govt	2,627	8,908	0.90	—	0.90	7.40
Colonial Govt Securities Plus Trust	724	2,005	1.12	0.41	1.53	12.64
Merrill Lynch Federal Securities Trust	1,639	4,821	1.05	0.35	1.40	10.28
Hutton Investment-Govt Securities	777	3,050	0.97	0.24	1.21	10.01
Criterion Bond-US Govt High Yield	0	1,126	0.94	0.47	1.41	10.72
American Capital Govt Securities	770	4,757	1.20	0.53	1.73	12.76
Shearson Managed Governments	412	1,470	1.46	0.04	1.50	13.40
Dean Witter US Govt Secs Trust	957	7,448	1.24	0.07	1.31	10.47
Investment Portfolio-Govt Plus (Kemper)	19	1,840	0.83	0.08	0.91	8.52
Prudential-Bache Government Plus[1]	—	3,918	0.60	0.15	0.75	10.00
Putnam High Income Govt Trust[2]	—	1,499	0.90	0.20	1.10	12.39
Shearson Lehman Long Government Index						
Lipper average of all fixed income funds						

*Assumes $5,000 investment. †Does not include sales charge. [1]Fund first offered 3/21/85; capital gains for 6 months only. [2]Fund first offered 3/1/85.

Sam can print dollars to redeem his own paper. But buying long-term bonds subjects the holder to market risk—the risk that rising interest rates will drive down the market value of bonds and thus the value of bond fund shares. If interest rates on long-term Treasurys rise to 9.5% from the 8.5% level of early March, long Treasurys will lose about 7% of market value. If interest rates rise to 10%, the loss will be about 10%.

Do the investors now stampeding into bond funds understand market risk? As best we can tell, hundreds of thousands of them don't. They think they are buying shares of high-yielding money market funds with virtually no risk of losing principal. One day—no, we don't know when—they will get a nasty surprise.

"People think the U.S. government is standing by to bail them out," says Kurt Brouwer of Managed Assets Plan, a Birr, Wilson & Co. subsidiary that analyzes mutual funds for clients. "What they don't understand is that Uncle Sam stands behind the securities in the funds, not behind the fund shares. If rates rise and the net asset values of the fund shares fall, Uncle Sam isn't going to do a thing to help them."

The table above provides an idea of how popular some government bond funds have become. The 13 funds in the table are the fastest growing, in terms of dollars, of the taxable fixed income funds open to the public. The 13 had $44.5 billion in assets at year-end, compared with $8.1 billion at year-end 1984. Among them, then, these funds accounted for about half the $71 billion of new money bond and income funds drew last year.

All 13 fastest-growing funds charge a sales load, a commission, ranging from 4% to 6.75%, even though investors can buy plenty of no-load funds whose performance is as good as these funds', or better. This won't surprise cynics, who know that investments are sold, not bought. But it should make an investor think before he parts with his money. Load funds pay commissions to the broker or financial planner who sells them. No-load funds, generally bought directly from fund management companies, carry no commissions.

In addition to the hefty one-time loads, fund managers charge investors annual fees and expenses that typically run about 1% of investors' money and can be as high as 2%.

The largest of these funds, Franklin Custodian-U.S. Government, charges its shareholders up to 4% to reinvest dividends in new shares. Few other load funds do that. With more than $10 billion in its care, Franklin's reinvestment fee transfers at least $13 million a year from investors' pockets to Franklin's, by our estimates. Some other funds nip you for 12b-1 fees—the name derives from the SEC regulation that permitted them—which amounts to the same thing under a different name. Loads, management fees, expenses, 12b-1s to cover "distribution costs"—have investors factored those into their calculations?*

With long-term government securities yielding 8.5%, and even GNMAs yielding 11% or less, taking 1% to 1.5% a year for expenses and fees cuts returns significantly. "There's a point

payouts made in the past 12-month period, when interest rates were much higher than now. And the yields quoted by some funds are based on their fixed regular payouts to investors, not on what the funds' underlying securities are actually earning. What's more, only 3 funds beat the 19.8% average total return for fixed income funds last year. And the returns don't take into account the hefty loads each fund charges.

Net asset value 12/31/84	Maximum sales charge	Total return† 12/31/84 to 12/31/85	Funds' claimed current yield	Funds' yield calculation	Fund
$15.07	4.75%	22.4%	10.5%	7-day avg dividend + gain, annualized / 7-day avg offering price	Van Kampen Merritt US Govt Fund
9.74	4.25	20.3	11.5	trailing 12 mos dividend / current offering price	PaineWebber Fixed Income-GNMA
7.10	4.00	20.0	11.4	trailing 12 mos dividend / current offering price	Franklin Custodian-US Govt
11.79	6.75	19.7	11.3	trailing 12 mos dividend + gain / offering price at end of period	Colonial Govt Securities Plus Trust
9.64	6.25	19.5	11.4	latest quarter dividend + gain, annualized / avg offering price in the period	Merrill Lynch Federal Securities Trust
10.01	5.00b	18.7	10.7	anticipated annual dividend + gain / current offering price	Hutton Investment-Govt Securities
10.00	6.75	18.1	11.8	current monthly dividend + gain, annualized / current offering price	Criterion Bond-US Govt High Yield
11.90	6.75	17.3	12.1	latest quarter dividend + gain, annualized / max offering price in the period	American Capital Govt Securities
12.77	5.00	17.1	10.1	7-day dividend + gain, annualized / current offering price	Shearson Managed Governments
10.47	5.00b	14.0	11.1	30-day dividend, annualized / 30-day avg offering price	Dean Witter US Govt Secs Trust
8.52	6.00b	10.6	10.7	latest quarter dividend + gain, annualized / current offering price	Investment Portfolio-Govt Plus (Kemper)
10.00	5.00b	NA	10.6	latest quarter dividend + gain, annualized / current offering price	Prudential-Bache Government Plus[1]
11.57	6.75	NA	12.8	latest quarter dividend + gain, annualized / current offering price	Putnam High Income Govt Trust[2]
		31.5			Shearson Lehman Long Government Index
		19.8			Lipper average of fixed income funds

b: back-end loads. NA: Not applicable. *Sources: Lipper Analytical Services; Shearson Lehman Brothers; fund documents; interviews with funds.*

at which the bond fund thing becomes an outrage, and we're getting really near that point," says John Bogle of Vanguard, whose firm sells no-load funds. "The typical fund is charging the investor about 1.5% [excluding loads] a year," he says. "Why would anyone in his right mind pay 1.5% a year to buy something yielding 8.5%? Anyone who does that doesn't have the facts."

Investors keep pouring billions into these funds because they think returns are higher than they really are. When we telephoned the funds to ask about current yield, we got figures ranging from 10.1% to 12.8%. If a fund owns Treasurys yielding 8.5% or GNMAs yielding 11% and then takes out fees and expenses, how can all the funds yield more than 10%? Easy. They change the definition of yield.

To us—and, we suspect, to the average person—yield means the fund's current interest income after expenses, divided by net asset value per share. For a load fund, we would divide interest by the offering price, which includes the sales commission investors pay.

But only one fund in our table—Dean Witter—sees things that way. For the other 12, definitions vary all over the place. Some take interest for a seven-day period and capital gains for the quarter, and project them for a year. Colonial takes the last 12 months of interest (higher then than now) and adds its capital gains for good measure. Hutton uses anticipated dividends and gains.

No one knows if a fund will have capital gains in a given year; calling such one-time income "yield" is absurd. Combining interest income and capital gains and calling it "total return" is fine. Calling it "yield" is clearly misleading.

Complicating matters are the GNMA funds, some of whose securities are, in fact, now yielding 11% or so. But investors are paying more than 100% of face value for them. As monthly payments on the Ginnies' underlying mortgages come in, and as mortgage loans are paid off early, which happens in a time of declining rates, the holders are whacked with a capital loss—which, you can be sure, is rarely reflected in the quoted yield.

The Investment Company Institute, the mutual funds' trade association, is drawing up a standard definition of yield that it hopes bond funds will adhere to someday. What of the Securities & Exchange Commission, meanwhile, which is supposed to protect investors from deceptive razzle-dazzle? The SEC's Lawrence Friend defines yield the same way we do. What's the commission doing, then? Making a little noise, waiting for the Investment Company Institute. Meanwhile, the money pours in, chasing hyped "yields."

Some fund managers—their funds often have the word "plus" in them—claim that they aren't selling plain old bond funds and charging high loads and fat fees. They claim to be enhancing income by selling options and de-

*Some funds that are now being promoted by brokers as being "no-load" are not quite that. They are no-load going in but have a back-end load as high as 6% if you redeem shares within a year, and they usually carry annual 12b-1 fees of as much as 1.25% of assets. Caveat investor.

creasing risk by hedging. They are plain enough about it—it's in their prospectuses.

Their favorite maneuver is writing—that is, selling—covered calls, which give the buyer the right to buy a security from the fund at a fixed price for a fixed period. Proceeds from selling calls enhance current income, obviously, but only at a price—reducing potential capital gains, because bonds that rise in price get called away. Among the foremost practitioners: American Capital Government Securities, Jerry Tsai's fund. In the Eighties, as in all history, there's no such thing as a free lunch.

"The most dangerous words in money management," quips Stanley Egener, president of Neuberger & Berman Management, "are, 'This time, it's different.'" The funds' performance shows that, "enhancement" notwithstanding, things aren't really different.

The 232 taxable fixed income funds tracked by Lipper Analytical Services averaged a 19.8% total return (interest earned plus capital gains) last year, while the 13 biggest funds, the ones in our table, averaged less than that. And those returns don't allow for the cost of sales charges. Even more telling, long-term government bonds showed a total return of 31.5% last year, according to the Shearson Lehman Long Government Index. The question investors must ask is: If fund managers' services are worth 1% to 1.5% a year, plus big loads, shouldn't their results at least match the return that bonds themselves earned?

Certainly, a 19.8% return is nothing to sneeze at. Even if investors were misled, they made out well. But can the fund managers do 19.8% again? Sure, if interest rates on long-term Treasury securities drop to 6.5% from 8.5% this year and then to 4% next year.

Some funds have been paying fixed periodic dividends, much like bank CDs, using both capital gains and interest income to fund the payouts. But declining rates have led one fund, Franklin Custodian, to say it expects to cut its payout to 7.1 cents a month per share from 7.5 cents. Van Kampen recently cut payouts to 15 cents a month from 16.25 cents. Others will doubtless follow.

Given recent declines in interest rates, the real-world yield on some bond funds could soon fall into the 7% to 8% range—8.5% to 9% for the underlying securities, less 1% to 1.5% for costs. That's about the same range as money market funds, even though the securities that money funds buy carry rates well below bond rates. It's a matter of competition. Virtually all money market funds are no-load, and don't dare pile on too many fees because reported returns would drop and investors, who can find money market fund yields printed in their local newspapers, would switch to another fund.

If money fund yields and bond fund yields do converge, why should income-oriented investors leave their cash in bond funds, where they will be running much higher risks with their capital while earning the same return money fund investors do?

If interest rates spike upward, thousands of investors who think they have high yield without high risk will painfully discover that their principal is shrinking—that what they really got was high risk without high yield. Their screams will fill the heavens. In such an event, can congressmen—and tight regulation—be far behind?

Will the sky fall tomorrow? Of course not. But unless the fund industry cleans up its act or investors suddenly get a lot smarter, the sky will come crashing down on everybody one of these days. Remember, you read it here first. ■

Frank Lorenzo hunts from a blind and talks of leverage, liquidity and profits. But most of all, he talks about . . .

Timing

By John Merwin

IT WAS THE VERY Saturday morning, Feb. 22, when, according to much of the nation's press, Texas Air Chairman Frank Lorenzo was madly negotiating to buy Eastern Air Lines. In fact, Lorenzo was sitting in a Houston hotel coffee shop, picking at a breakfast of fruit and hot cereal and musing with FORBES about his business. Dressed casually in a blue blazer, plaid shirt and tan rubber-soled shoes, Lorenzo was chatting not just about Eastern but, more generally, about big-game hunting in the airline industry.

His immediate quarry, of course, was Eastern. If the Eastern deal is completed, in less than a decade Frank Lorenzo will have vaulted from chief executive of a pip-squeak, presumptuously named airline, Texas International Airlines, to leader of the largest airline holding company in the noncommunist world, a network including Eastern, Continental Airlines and New York Air.

Why Eastern? Why now? Why not six months ago, or six months from now? Why not TWA or People Express? In the airline industry Lorenzo's ability to raise airlines (Texas International and Continental) from the near dead is legendary. But so is his reputation as a union basher and thrasher of labor. So why Eastern, the sickest on the industry's sicklist of airlines? After all, under the weak and indecisive management of Chairman Frank Borman, Eastern let employee relations deteriorate to the breaking point, even as labor costs hovered higher than those of any major carrier. Meanwhile, the company rushed ahead with capital investments that burdened the airline with some $1.5 billion in new debt.

"Timing," answers Lorenzo. It's all timing—like waiting in a duck blind for the ducks to drift over. In Eastern's case the inducement was not the routes, nor even the planes. Lorenzo had Eastern in his sights because of its union woes. Now two of the line's three union contracts were up, and Lorenzo had squeezed the trigger.

It was the same last fall for Frontier Airlines, and before then, TWA. At TWA, labor contracts were expiring,

How can bank regulators deal with bad Latin American loans without starting a run? One way is to talk about letter-of-credit guarantees instead.

Slow-burn panic

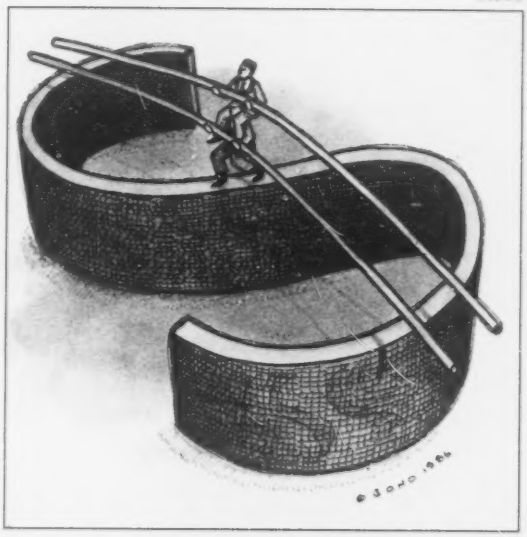
By Mark Clifford

SHOUTING "FIRE!" IN A crowded theater is unwise, even if the curtain is smoldering. Better to whisper and hope to empty the room slowly.

How else explain the Federal Reserve's attack on off-balance-sheet credit guarantees? The Fed wants banks that do a lot of these letters of credit to build up their capital cushion. But the fire isn't only there. It's in the billions of dollars in Latin American loans that will be paid off late or never. Yet the Fed can't afford to create a Latin-loan panic.

So far, the government's official hear-no-evil, see-no-evil treatment of Latin loans means that banks carry these loans at close to face value. That position is getting untenable, with Peru, Mexico and now Brazil vowing to limit repayment of debt. In this context, the rules requiring more capital to back domestic credit guarantees should be understood as a cautious play for stronger balance sheets.

"The Fed is worried about a few key institutions, so they're forcing the entire industry to raise capital," says a money center bank executive who deals with regulators on capital adequacy and loss reserves. "Regulators were criticized after Continental's near-failure, so they're attempting to prevent similar episodes, but they don't want to alarm the man in the street by talking about the banks' problems." So why not simply force banks to write off, say, 15% of Latin American loans, much as regulators in Canada and West Germany have done? "A 15% charge would be a crippling blow for some banks," says the banker.



The Fed's proposal is sensible enough and long overdue. It would penalize banks for having a heavy involvement in so-called off-balance-sheet items—financial guarantees like standby letters of credit and contingent loan commitments. In a typical arrangement, the Delaware Medical Center raises money by selling bonds to investors, and Bankers Trust, in effect, cosigns the IOU. If the hospital gets into

Vicarious capital

The Fed seems to think it tactless to demand more capital from banks with heavy Latin loans. But it may demand more capital from banks with heavy off-balance-sheet loans—as it happens, often the same banks.

Bank	Total assets[1] (billions)	Return on equity	Primary capital to assets current rules	Primary capital to assets proposed rules	Capital needed to raise adjusted ratio to 6.5% (millions)	Latin American loans as % of primary capital[1]
Citicorp[2]	$173.6	14.3%	6.23%	6.05%	$815	97%
BankAmerica	118.5	–6.8	6.11	5.81	867	94
Chase Manhattan	87.7	13.3	6.87	6.30	195	110
Manufacturers Hanover	76.5	11.9	6.31	5.62	768	149
JP Morgan	69.4	17.4	7.96	8.22	—	69
Chemical	57.0	14.6	7.02	6.32	113	92
Security Pacific	53.5	15.3	6.39	6.48	11	30
Bankers Trust	50.6	16.1	6.35	6.16	178	46
First Interstate[3]	49.0	13.1	6.20	6.67	—	49
First Chicago	38.9	8.4	7.24	6.81	—	62

All information as of 12/31/85 except Latin American loans (12/31/84). [1]Includes Argentina, Brazil, Chile, Mexico and Venezuela. [2]Citicorp's disclosure of foreign loans is far more complete than other banks; therefore, figure is not fully comparable. [3]Includes six largest banks in system.

Sources: IBCA, Inc.; Goldman, Sachs.

trouble, the bank has to make good the loss. Bankers Trust collects a fee for cosigning.

Right now, such a guarantee isn't considered a loan by the bank, and the bank doesn't have to have capital standing behind it. (The "primary capital" cushion consists mainly of shareholders' equity plus loss reserves.) Meanwhile, riskless investments like Treasury bills are counted in the asset total against which a minimum 5.5% primary capital must be maintained. Under the proposed Fed rules, T bills would no longer be counted as assets in determining the minimum acceptable capital. Letters of credit would be counted.

Not every bank would be penalized by the new rules. J.P. Morgan already boasts one of the highest primary capital ratios (7.96%), considerably above the minimum. If the Fed proposal takes effect, Morgan would have even more excess capital.

At the other end of the scale are banks, now on the edge of the capital minimum, that would be in worse shape. An analysis by Fred DeBussey at IBCA, Inc., the U.S. arm of the London-based bank rating firm, points to several as particularly vulnerable—BankAmerica, Chase Manhattan, Chemical and Manufacturers Hanover—that would therefore see their capital ratios decline significantly under the proposal. All four have big loans to Latin America.

There are two ways for an undercapitalized bank to shape up. One is to cut back off-balance-sheet activity, which would cost it lucrative fees, ⅛% to 1½% of the amount guaranteed. The other is to sell more stock. That alternative is unpalatable because it tends to pull down the bank's return on equity. If a bank sells $100 of stock and lends it out at 10%—5% aftertax—its return on that additional equity is a pathetic 5%. The only way for a bank to earn its target of 15% or so is to leverage a little bit of equity into a lot of borrowing and lending.

Financial guarantees are big business to some banks. The industry's standby letters of credit more than quadrupled between 1980 and 1985. At the end of September ten large banks together had more than $334 billion in these shadowy obligations. Moody's Investors Service, specifically citing heavy off-balance-sheet commitments and few prospects for growing out of the problem, recently downgraded its ranking of Manufacturers Hanover debt. It was the first such move by Moody's, but it seems all but certain that it will be getting around to other banks.

As the table shows, the worst a large bank can expect from the proposal is a demand for another shot of equity equal to 0.79% of assets.

But this could merely be a downpayment. If the Fed stepped up the minimum capital from 5.5% to 6.5%, Citicorp and BankAmerica would need more than $800 million in new money. And some regulators have been saying that the minimum should eventually be ratcheted up to 9%. Even though they aren't confronting Latin American debt head-on, the Feds are evidently worried. ■

Two years ago many figured Columbus-based Banc One was in real trouble. Not quite. Thanks to carefully focused marketing, Banc One today is a Midwest powerhouse on an aggressive shopping spree.

Some lessons for the big boys

By Barry Stavro

HERE'S BASIC MATH according to John B. McCoy, chief executive of Banc One Corp.: "If I go into a transaction with $1 and I end up with 95 cents, well, why in the hell would I ever want to do that?" It's a lesson in how acquisitions can dilute earnings, particularly timely now that interstate banking has hit the Midwest, and the race is on to buy banks in new territory.

Certainly McCoy has the buying power. Banc One, with $10.8 billion in assets, has common stock outstanding worth some $1.8 billion, the highest market capitalization of any Midwest bank, including such leaders as First Chicago, which has nearly four times Banc One's assets. Banc One's stock trades at 28, more than double its $12.13 per-share book value. The difference is its sterling performance record. Since last fall McCoy has moved fast, striking deals worth $190 million (in stock) to buy ten banks in Kentucky, Michigan and Indiana with combined assets of $1.8 billion. These are pip-squeak banks. McCoy could cover more ground buying bigger ones, but takeover fever has afflicted the larger banks, resulting in higher multiples. McCoy won't make a deal if it dilutes earnings. Why? "I own the stock," he says.

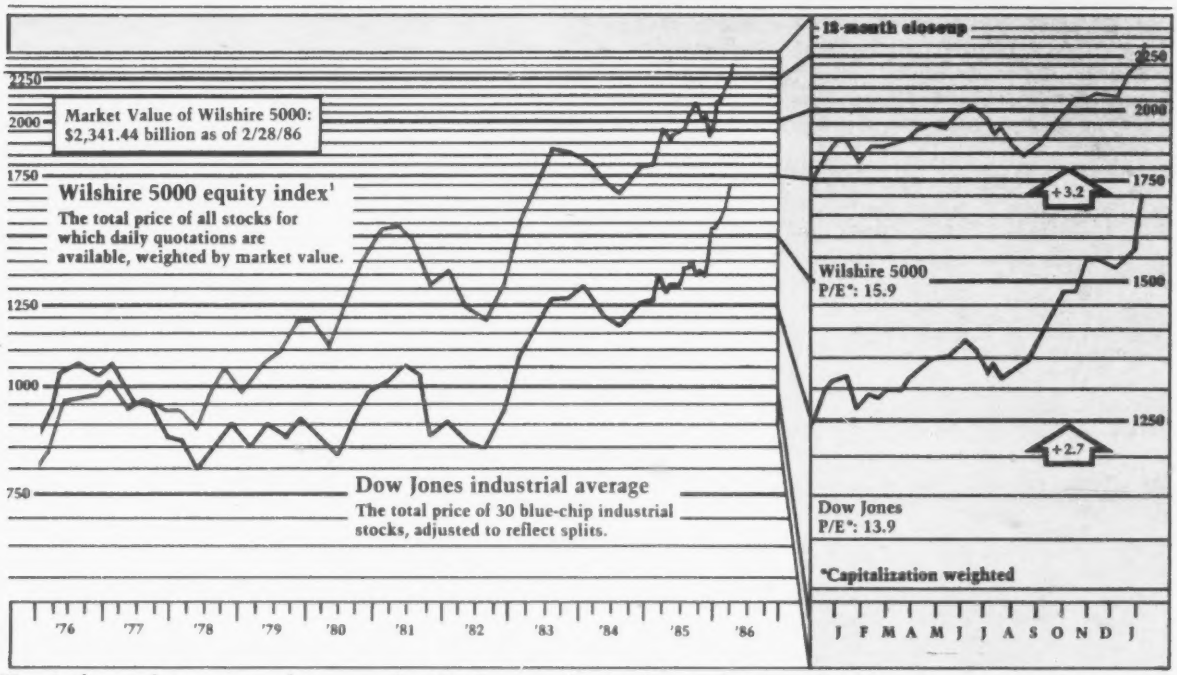
Indeed, Banc One insiders control 11% of the stock, and McCoy and his family's shares are worth about $8 million. Earnings have improved every year since 1968. Last year Banc One's profits hit $130 million, or $2.01 per share, up from $108 million, or $1.74, in 1984. This year analysts look for maybe $2.25 per share.

Banc One is part of an emerging breed of new banking powerhouses that show earnings performance and balance sheets that shame most money center banks. Energy, agriculture and foreign loans amount to less than 2% of Banc One's portfolio. Its nonperforming loans are 1.3% of the portfolio. Banc One doesn't chase after big corporate customers. Instead, it plies the more profitable middle market, lending to companies with, say, $5 million sales and up, and pushing retail lending like credit cards (13% of its loans). "I don't think there's ever been a bank that's failed because of bad installment loans," McCoy notes. Last year Banc One's 1.37% return on assets was the best performance of the 40 largest banks.

This is partly because of McCoy's successful small-town strategy, a canny combination of cost-cutting and well-focused retailing. "It's like Wal-Mart," he says. Since it's already among the biggest bank credit card processors, with nearly 6 million accounts, when Banc One takes over a small bank's data processing it immediately wrings out economies of scale.

The Forbes/Wilshire 5000 Review

Edited by Steve Kichen



Hasn't the market gotten rather expensive? With gains of 3.2% for the last two weeks and 7% for the last four weeks, the Wilshire 5000 ratcheted up to 15.9 times latest 12-month earnings. This exceeds, by a full point, the previous high multiple on the Wilshire, set in June 1983.

The bulls' justification: Inflation is low. But remember, inflation over the past 12 months was 4%, vs. 3.5% over the 12 months up to the June 1983 high. Also: Declining inflation ought to be a bullish sign for bonds, not stocks. Stocks are already well (although not perfectly) insulated against inflation. Bonds are totally unprotected.

Next excuse: Earnings will go up. For The Forbes Sales 500, for example, analysts are predicting a 23.8% higher earnings gain this year over 1985, followed by another 13.2% gain next year. Very respectable. But if investors become nervous about profits—or if they stop bidding up stocks merely because bond prices are going up—the averages could move down in a hurry.

Closeup On The Equity Markets

Performance of six leading indexes

Percent change	Wilshire 5000	Forbes 500[2]	Dow Jones industrials	NYSE Composite	Amex Market Value Index	NASDAQ Composite
in last 4 weeks	7.0	6.5	8.8	7.0	5.5	7.1
in last 52 weeks	23.8	26.1	31.6	23.3	12.6	25.2

Stock performance based on six key investor yardsticks

Percent change	Company size		Volatility[3]		P/E multiple		Dividend yield		Growth profile[4]		Share price	
	large	small	high	low	over 25	under 5	over 7.5%	none	high	low	over $40	under $4
in last 4 weeks	7.7	5.9	8.8	5.0	6.0	7.9	5.3	5.4	6.8	7.2	8.7	2.3
in last 52 weeks	28.0	26.7	42.4	31.5	18.2	34.5	26.2	29.6	38.9	35.7	39.1	9.6

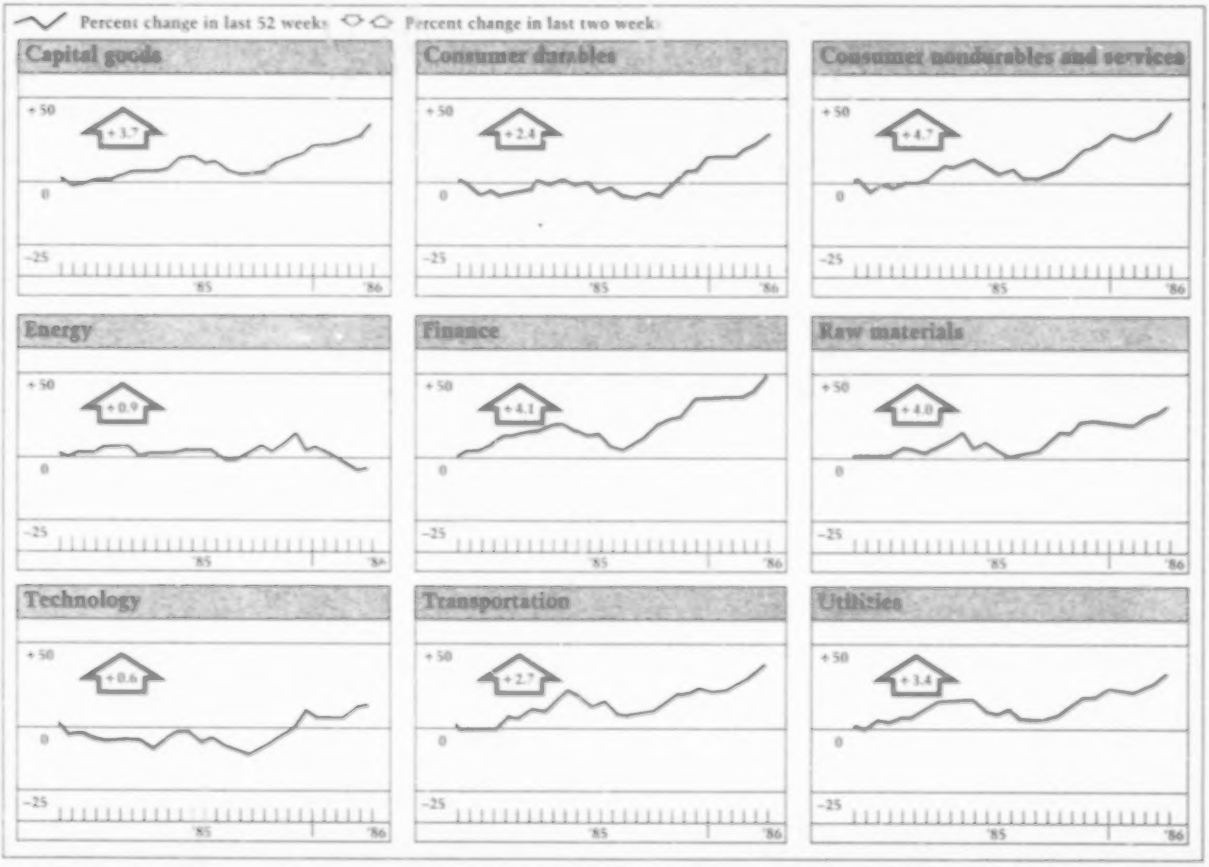
[1]Wilshire index reflects price performance. It differs slightly from market value of outstanding stocks because of retirements of equity since index was created.
[2]Based on sales.
[3]A stock's sensitivity to overall market movement. High-volatility issues have wide price fluctuations, low-volatility issues are more stable.
[4]A quantitative evaluation of a stock's growth image, determined by Wilshire Associates.

Note: All data for periods ending 2/28/86. Prepared by Wilshire Associates, Santa Monica, Calif.

Gay French

Where The Action Is

Why bankers are smiling. On top of the heap for 52-week performance, with a 39.5% gain, is the finance sector. Yes, the prospects at some commercial banks have been dimmed somewhat by loans to the oil industry and Third World nations. Nevertheless, most of these companies have benefited from declining interest rates, takeover fever and the growth of regional interstate banking. Lower interest rates and the maturing of older, lower rate mortgages has also helped the savings and loan stocks *(see p. 207)*. The best-performing major finance stock is Financial Corp. of America, which is benefiting greatly from lower rates but still has a lot of work to do cleaning up a portfolio of bad loans. In the last two weeks this stock jumped nearly 32%.



What The Analysts Think

Revised edition. In the last two weeks Wall Street raised, slightly, its 1986 estimates for finance and consumer durable stocks. Truer to form, however, security analysts had second thoughts about their earlier, more optimistic, projections for the seven remaining sectors. For the energy group, analysts slashed their forecasts by nearly 3.9%.

Forecasting the Forbes 500

Performance period	Average earnings per share	P/E
latest 12 months	$3.14	14.8
1986 estimates	4.13	11.2
1987 estimates	4.87	9.8

Rank based on change in estimate	Sector	Estimated 1986 EPS	Estimated 1986 P/E	% change in 1986 estimate in 2 weeks	% change in 1986 estimate in 4 weeks
1	Finance	$3.85	10.5	0.81%	1.56%
2	Consumer durables	4.37	8.9	0.17	0.07
3	Capital goods	2.84	13.7	-0.03	-0.10
4	Consumer nondurables	2.53	14.0	-0.11	2.56
5	Utilities	3.35	9.1	-0.34	-0.57
6	Technology	2.87	13.8	-0.55	-1.53
7	Transportation	2.62	11.8	-0.58	-1.68
8	Raw materials	2.29	13.9	-0.75	-1.46
9	Energy	3.36	8.3	-3.86	-6.81

Earnings projections are capitalization-weighted consensus estimates from over 2,000 security analysts. Data are compiled and updated continuously by the Institutional Brokers Estimate System (IBES), a service of Lynch, Jones & Ryan, a New York-based brokerage firm.

Note: All data for periods ending 2/28/86. Prepared by Wilshire Associates, Santa Monica, Calif.; IBES, a service of Lynch, Jones & Ryan, New York.

Currently, the cattle market is being cleared of overweight animals. This brightens the prospects for higher prices.

TRIMMING THE FAT

By Stanley W. Angrist

The cattle market has looked sick in recent weeks. Nearby contracts have been weakest because there is no shortage of animals ready to come to market. Heavier-than-projected slaughter—with kill levels running 3% to 4% ahead of last year—has had a major bearish influence on cattle market participants. January slaughter records show that cow kill is up more than 10% from last year. Steer and heifer kill are running 2% ahead of 1985, about in line with expectations.

There were 9% fewer cattle-on-feed on the first of January in 13 states than a year earlier. That's a smaller number on feed for this time of year than in any of the last 16 years except in 1982 and 1975. The only increases from last year in cattle-on-feed were in the heavyweight groups, steers weighing over 1,100 pounds and heifers weighing over 900 pounds. There were 15.5% fewer steers and heifers on feed weighing less than 900 pounds.

Meanwhile, the estimated inventory of all cattle and calves on farms on Jan. 1, released on Feb. 10, was bullish for cattle, showing a decline of 4 million head from this time last year. The report confirmed expectations: We now have the smallest cattle inventory since 1963. The "Seven State Cattle-on-Feed Report," released on Feb. 14, showed that total feedlot population on Feb. 1 was down 7% from a year earlier. Traders were prepared for a bigger drop and initially sold the market with a vengeance.

These reports all tell me the same thing. Once the heavier-weight cattle are cleared out of the pipeline, higher prices are on the way. Phil Tiger, who publishes a newsletter that tracks spreads in all of the commodity markets, has found a trade that logically fits with these fundamentals. (For information write: *Tiger on Spreads*, P.O. Box 1414, McLean, Va. 22101). Tiger has tracked the spread of long June/short October cattle since 1969. He found that the spread has widened in 16 out of 17 years. (That does not necessarily mean that profits would have been made in 16 of 17 years. One could have put the spread on, thinking it was as narrow as it was going to get, only to find it narrowing further, stopping one out with a loss. It then could have widened, resulting in a profitable trade.)

On average, the spread widened 450 points (ignoring the losing year of 1985), or $1,800 from its low point (usually occurring in the December through February period) to its high point (generally made in the April through June period).

Given the existing fundamentals, the spread is worth trying this year. I would put it on, with June at no more than a 350-point premium to October, and look for at least a 250-point profit ($1,000 per spread). That means I expect it to make about an average move of 450 points or so from its low point of 170 points June over October. I would risk 100 points ($400 per spread) from my entry. The margin on this spread is $500, while the round-turn commission at a discounter would be around $50.

Another way to play this spread would be to buy the June 60 call, while selling the October 60 call, for a net debit of 100 points, which means the trade would cost you $400 per spread. Look for the spread to widen by at least 150 points. ■

Stanley W. Angrist is a commodity speculator, consultant and longtime observer of the commodity markets.

Steering for profits

The table shows ten years of the June versus October cattle spread, and the consistency with which it has widened. Though the table starts with 1977, the pattern dates back to 1969. Current fundamentals indicate that traders could profitably take advantage of this relationship. (Note: Under the "Spread low" column, a minus sign means that June was selling at a discount to October.)

Year	Date of low	Spread low (points)	Date of high	Spread high (points)	Maximum net change (points)
1977	1/5/77	–120	5/2/77	260	480
1978	1/5/78	–50	5/31/78	380	430
1979	11/15/79	–50	3/22/79	530	580
1980	4/18/80	15	4/28/80	290	275
1981	1/28/81	20	4/29/81	445	425
1982	12/15/81	100	6/1/82	980	880
1983	11/26/82	150	6/11/83	780	630
1984	10/28/83	230	3/1/84	590	360
1985	6/1/85	–300	11/20/84	450	–750
1986	12/20/85	170*	1/27/86	390*	220*

*To date.